No. 11,146

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

PACIFIC PUBLIC SERVICE COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S REPLY BRIEF.

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Prior to 1935 petitioner held certain capital obligations of its subsidiary, California Consumers Company. In 1935, under bankruptcy section 77B, the company was reorganized and taken over by California Consumers Corporation. The schedule at the back of this brief shows the securities involved, petitioner's holdings and their cost, the new securities received by petitioner and their basis as determined by the Tax Court in computing petitioner's loss on the subsequent sale of these securities in 1940. On this schedule we have shown in black type the figures regarding Lot B, which is the sole feature of this transaction involved in our appeal. The only question presented by the appeal is whether under the statutes the original basis, petitioner's investment in this note, carries over to the shares received in exchange on reorganization.

The Tax Court held the shares had to take a new valuation. We submit that the old basis should carry over.

Much of respondent's brief is devoted to an attempt to inject into this appeal an entirely different question. Prior to the reorganization, suit was begun against petitioner.[1] On reorganization the suit was dismissed.[2] Asserting that this presents issues that require further trial in the Tax Court, respondent seeks a remand for that purpose.[3] We submit that respondent is not in a position now to raise this question, and, further, that on the merits respondent's point is groundless.

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1. **THE ORIGINAL COST OF THE SECURITY SHOULD FOLLOW THROUGH THE REORGANIZATION AND BECOME THE BASIS FOR THE SECURITIES ISSUED ON THE EXCHANGE.**

This point is fully discussed in our opening brief. Of the authorities touching it, upon which respondent relies, all but one are analyzed in our opening brief. The one new authority mentioned by respondent is the *Lloyd-Smith* case.[4] Like the two other cases, in connection with which it is cited,[5] the *Lloyd-Smith* case is essentially different from the case at bar. The note under discussion in this case was a note of the recapitalized company, not of the old company that went into the reorganization, as here. In

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[1] R. 113-118, 118-145.
[2] R. 63, 113-119.
[3] Resp. Br., pp. 4, 7, 17-18.
[4] *Lloyd-Smith v. Commissioner*, 116 F.(2d) 642; Resp. Br., p. 10.
[5] *L. & E. Stirn, Inc. v. Commissioner*, 107 F.(2d) 390; Resp. Br., p. 10; Op. Br., p. 18;
Commissioner v. Sisto F. Corp., 139 F.(2d) 253; Resp. Br., p. 10; Op. Br., pp. 14-15.

this case the note under discussion was not, as here, the note of a subsidiary held by the parent corporation. Respondent's reliance upon this case is based entirely upon a false theory of nominalism. This case reached the conclusion that the note there involved was not a "security" within the meaning of the income tax law. That being true of the interest denominated a note in this case, respondent concludes that in no case can an interest, denominated a note, be included under the term "security". Respondent's theory is not even good nominalism. In the instant case the bonds, both of the old and new companies, are treated as "securities". These "bonds", however, were nothing but "promissory notes". No legal distinction exists between a "bond" and a "note". The true basis of all the decisions is realistic, rather than nominalistic. The court considers in each case all the circumstances of the relation between the "security" holder and the corporation, in order to determine whether that interest is such a property interest as to come within these income tax provisions.

A circumstance of the greatest importance in the instant case is the fact that petitioner held all the common stock of the old company, as well as holding the note. Under such conditions, common stockholders may not realize upon the indebtedness to the prejudice of others interested in the company.[6] Interest on such a note is treated as a dividend.[7]

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[6] *Taylor v. Standard Gas Co.*, 306 U.S. 307, deferring indebtedness to preferred stock;
Pepper v. Litton, 308 U.S. 295;
Arnold v. Phillips (5th C.C.A., 1941), 117 F.(2d) 497.

[7] *Prudence Securities Corporation v. Commissioner* (2nd C.C.A., 1943), 135 F.(2d) 340.
See also *Arnold v. Phillips*, supra.

As pointed out,[8] the old company was reorganized under the Bankruptcy Act. In such cases the best view is that all creditor interests are securities and must be so treated for income tax purposes. Respondent concedes that this is true where the old company is insolvent, but refers to the decision of the Tax Court.[9] This seems to be a suggestion that in this case the old company was not insolvent. Respondent cannot really mean this. Insolvency was expressly stipulated[10] and found.[11] Respondent valued the securities of the new company on bases that make the total value of the new securities issued on the reorganization $1,245,667.25[12] against $3,496,500 bonds and a $478,270 note. Respondent cannot seriously suggest to this Court that the old company was not insolvent.

Realistically the test whether or not an interest is a security, within the meaning of these reorganization provisions, must be based upon consideration of the extent to which the holder's interests are bound up with those of the company, and, conversely, of the ease with which the holder can obtain his money and divorce himself from the company. Only thus can cases of this kind be brought in line with the spirit of the reorganization provisions.[13]

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[8]Op. Br., pp. 8-16.

[9]Resp. Br., pp. 16-17; R. 158-160.

[10]R. 46.

[11]R. 152.

[12]See appended schedule.

[13]"The underlying assumption of the exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganization, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated" (sec. 29.112(a)-1, Treasury Regulations 111, Income Tax, p. 347).

"The reorganization provisions were enacted to free from the imposition of an income tax purely 'paper profits or losses' wherein

Considered from this standpoint, it is quite clear that petitioner could at no time have collected its $478,270 note, and that, throughout the reorganization, all petitioner's interests in the company were firmly bound up with the interests of the ultimate reorganized company.[13a]

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2. NO FURTHER PROCEEDINGS OR ADJUSTMENTS ARE REQUIRED.

Respondent's effort to reopen the proceedings, so that he may offer evidence ascribing some value to the lawsuit dismissed, comes too late.

(a) Respondent did not plead anything of the kind.

Nothing in respondent's allegations in the Tax Court seeks to ascribe any value to this litigation.

(b) At the trial, respondent offered no evidence that the litigation had any value.

Respondent offered the proceedings in the litigation.[14] No evidence was offered to show either that the dismissal of the litigation had any value or that the charges against petitioner, made in the litigation, had any substance. At

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there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form, the tax being postponed to a future date when a more tangible gain or loss is realized'' (*Commissioner v. Gilmore's Estate* (3d C.C.A., 1942), 130 F.(2d) 791, 794).

''The recognized purpose and scheme of the reorganization provisions is to omit from tax a change in form and to postpone the tax until there is a change in substance or a realization in money'' (*Morley Cypress Trust* (1944), 3 T. C. 84, 86).

[13a]The unsecured creditors of the insolvent company other than petitioner were not affected by the plan of reorganization (R. 62).

[14]R. 114-117.

the time, the Tax Court pointed this out. "The charge * * * was never adjudicated * * * I don't know what conclusion we can draw from it. Someone makes a charge and that is as far as it goes. * * * It is not anything. I charge that you owe me a million dollars and that is the end of it. It doesn't prove you owe the million dollars. * * *[15] it is sort of like the counsel who asks the witness if he didn't lie, and he says, 'No, I didn't lie'. Then you say, 'Well, maybe he lied'. Somebody makes a charge and they don't pursue it, and I don't see how I can draw any conclusion on that."[16] Whatever may be said of the nature of respondent's point on the merits, there is no doubt that he was given ample warning of this defect of proof. He did not attempt to supply the defect. He immediately submitted the case.[17] All that respondent is now asking is that he be permitted on remand to supply the defect that he disregarded at the trial. He offers no authority for his proposal that he be accorded this privilege of trying the case piecemeal. He suggests no reason why he did not take advantage of the opportunity afforded in the Tax Court and present at the first trial any evidence he may have on these points.[18]

(c) The dismissal was not consideration for the note.

Nothing in the record indicates that the dismissal was part of the consideration for the surrender of the note. The plan of reorganization simply treats each one of these things separately. Respondent states, indeed, its contention "that the dismissal * * * was part of the con-

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[15]R. 115.
[16]R. 117.
[17]R. 117.
[18]But see *Retzer v. Wood*, 109 U.S. 185, 188.

sideration * * * for the surrender of the * * * note,"[19] and says that was respondent's contention below. There was no evidence in support of such a contention, and respondent does not suggest that such evidence could be available on a retrial.

(d) No property was acquired by the dismissal.

Respondent bases its claim upon section 113 (a) (6). This deals entirely with "property acquired" on an exchange.[20] Respondent overlooks the fact that this dismissal did not result in the *acquisition* of any *property* by petitioner. After the dismissal no one could point to any specific thing held by petitioner and say that petitioner acquired that by the dismissal of the litigation. The only authority cited by respondent is *United States v. Hendler,* 303 U. S. 564.[21] That case was essentially different. On the completion of the reorganization the taxpayer actually had a property right, the obligation of the new company to discharge the taxpayer's bonds. That obligation was a thing of value. The performance of that obligation would enable the taxpayer to remove from its books the liability of those bonds appearing on its books. In the instant case petitioner did not have any liability on its books that could be removed by the dismissal of the litigation. It could not possibly *gain* from the dismissal of the litigation. It acquired no property thereby.

(e) Respondent has not appealed.

Respondent urges that the dismissal of the litigation had something to do with the note held by petitioner,[22]

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[19]Resp. Br., p. 18.
[20]Resp. Br., pp. 18, 23.
[21]Resp. Br., p. 18.
[22]Supra, p. 2.

Lot B in the annexed schedule. The fact is that the litigation dealt with dividends upon the common and preferred stocks of the old company.[23] It was connected, therefore, with the common and preferred stocks, Lots A and C, on that schedule. Certainly it has no connection with the note, Lot B. The Tax Court's ruling on Lot A was adverse to petitioner. Petitioner has not sought to reopen that question here. The Tax Court's ruling on Lot C was in favor of petitioner. By an appeal, respondent could have raised that question here. Respondent did not appeal.

It is respectfully submitted:

1st. That for the 3,287.5 shares of the stock of the new corporation, issued to petitioner in exchange for the promissory note of the old corporation, petitioner is entitled to compute its 1940 loss on the basis of the original cost of the note, $478,270; and

2nd. That respondent is not entitled to any further proceedings before the Tax Court in an effort to obtain some adjustment of that figure.

Dated, San Francisco,
March 11, 1946.

Respectfully submitted,
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[23] R. 119-144.

CAPITAL OBLIGATIONS

	California Consumers Company			California Consumers Corporation				
	Cost to Petitioner	Total Outstanding	Petitioner's Holding	Total Issued	Issued to Petitioner	Basis Determined by Tax Court	Respondent's Valuations Issued to Petitioner	Total Issue
		25,000 shares common stock[5]		Nothing[9]				
Lot A	$ 6,000.00[1]		25,000 shares common stock[5]		Nothing[9]			
		$478,270 note[6]		3,287.5 shares[10]				$ 1,643.75[17]
Lot B	478,270.00[2]		$478,270 note[2]		3,287.5 shares[10]	$ 1,643.75[15]	$ 1,643.75[17]	
		15,343 shares preferred stock[7]		23,014.5 shares[11]				11,507.25[18]
Lot C	51,001.75[3]		902 shares preferred stock[3]		1,353 shares[13]	$51,001.75[16]	676.50[18]	
		$3,496,500 bonds[8]		$3,496,500 bonds[12]				
				27,972 shares[12]				1,232,516.25[21]
Lot D	54,877.66[4]		$75,000 bonds[4]		$75,000 bonds[14]			
					600 shares[14]	$ 54,877.66[16]	26,437.50[20]	
	$590,149.41					$107,523.16	$28,757.75[19]	$1,245,667.25

1 R. 147, 151.
2 R. 47, 48, 57-58, 152.
3 R. 48, 151.
4 R. 48, 151-152.
5 R. 47-48, 58, 152.
6 R. 47, 57-58, 152.
7 R. 47, 58, 152.
8 R. 47, 58, 152.
9 R. 46, 50, 62, 153-154; Resp Br pp 3, 4.
10 R. 46, 50, 60, 61-62, 153-154; Resp. Br. pp. 3, 4.
11 R. 46, 60, 153; Resp Br. p. 3.
12 R 46, 60, 153; Resp. Br. p. 3.
13 R. 50, 60, 154; Resp. Br. p. 4.
14 R. 50, 60-61, 154; Resp. Br. p 4.
15 As determined in computation under Rule 50. See R. 165.
16 R. 161; Resp. Rr. p. 6.
17 From last column.
18 Computed on basis of unit price in last column, 50¢ a share.
19 R 23.
20 Subtracting above figures from total shown below.
21 Computed from last column at unit price of $352 50 for each unit of $1,000 bond with 8 shares appurtenant.